No. 16025

United States
COURT OF APPEALS
for the Ninth Circuit

KLAMATH MEDICAL SERVICE BUREAU,
Petitioner,

vs.

COMMSSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REHEARING

Appeal from the Tax Court of the United States

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TABLE OF AUTHORITIES

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TO THE HONORABLE ALBERT LEE STEPHENS, CHIEF JUDGE, and HOMER T. BONE and STANLEY N. BARNES, CIRCUIT JUDGES, CONSTITUTING THE COURT IN THE ORIGINAL HEARING HEREIN:

With reluctance because of the known burdens carcried by this Court, but with the firm and sincere conviction that the opinion of this Court is contrary to and an extension of existing tax law, petitioner, Klamath Medical Service Bureau, respectfully requests that a rehearing be granted and the opinion rendered herein be reconsidered and set aside.

Petitioner came to this Court asserting that a decision rendered by the Tax Court of the United States holding that certain payments to stockholder employees were distributions of profits was erroneous.

Two grounds are set forth by this Court as the basis for its opinion. In affirming the Tax Court, this Court held (1) that the ultimate finding of fact of the Tax Court was not clearly erroneous; and (2) that the payments here in question were not "necessary" as required by Section 23 (a) of the Internal Revenue Code of 1939, since they were in addition to amounts required to be paid under the contracts of employment.

The second ground of this Court's opinion will be further considered below. However, it should be pointed out that this portion of the opinion is contrary to the authorities cited in Respondent's letter dated December 30, 1958, addressed to the Clerk of this Court, which stated that the Judges who participated in the case might wish to reconsider the wording of the opinion in regard to this second ground. A copy of this letter of Respondent is attached to this Petition as an appendix. Since Respondent joins in questioning this Court's expression of its second ground, it seems appropriate for this Court to not only reconsider the second ground, but also to determine whether the conclusion reached can be supported by the "not clearly erroneous" rule alone.

It is and has been Petitioner's contention that the major issue to be determined is not a question of fact. The question may best be phrased: Did the Tax Court

employ the proper criteria under the statute and regulations for ascertaining whether the purported compensation was, in fact, a distribution of profits. *This is a question of law. Collins v. C.I.R.,* 216 Fed 2d 519 (CA 1st, 1954); *Hoffman Radio Corporation v. C.I.R.,* 177 Fed 2d 264 (CA 9th, 1949); *Mayson Manufacturing Co. v. C.I.R.,* 178 Fed 2d 115 (CA 6th, 1949); *Zanuck v. C.I.R.,* 149 Fed 2d 714 (CA 9th, 1945), and *Maytag v. C.I.R.,* 187 Fed 2d 962 (CA 10th, 1951).

It is "clearly erroneous" as a matter of law for the trier of the fact to refuse to employ the correct criteria, *Mayson Mfg. Co. v. C.I.R., supra,* or to employ the "wrong or insufficient criteria or criterion," *Maytag v. C.I.R., supra,* in arriving at its determination of a question of fact.

Petitioner asserts that the Tax Court did not properly consider four well established criteria in reaching its decision and instead employed criteria which cannot support its determination. In the alternative, it is submitted that none of the facts upon which Respondent relies can be considered substantial in resolving the issue to be determined, and, at the very least, the clear weight of the evidence is in favor of Petitioner. Compare *Mayson Mfg. Co. v. C.I.R., supra,* at p. 119.

The principal argument of petitioner on appeal was that the findings of the Tax Court established all of the elements necessary to require a holding that the payments made to employee stockholders of Petitioner were compensation. The opinion of this Court confirms that Petitioner established: (a) the total amounts paid

were characterized as compensation for personal services actually rendered; (b) the payments were in proportion to the services rendered; (c) the payments were disproportionate to stockholdings; and (d) the payments were reasonable in amount.

All of the authorities to date have used the existence or nonexistence of one or more of these criteria in determining whether amounts paid as compensation were in fact dividends. See, for example, *Ox Fibre Brush Co. v. Blair,* 32 Fed 2d 42 (CCA 4th, 1929), where the Court emphasized the fact that the board of directors characterized the payments as compensation; *Am-Plus Storage Battery Co. v. C.I.R.,* 35 Fed 2d 167 (CCA 7th, 1929), where the principal issue was considered to be reasonableness; *Heil Beauty Supplies v. C.I.R.,* 199 Fed 2d 193 (CA 8th, 1952), where the primary consideration was the failure of the employee to render services in proportion to the amounts received; and *Long Island Drug Co., Inc.,* 35 BTA 328, affirmed 111 Fed 2d 593 (CCA 2d, 1940), cert. denied 311 U.S. 680, where payments in proportion to stock ownership was stressed. No case discovered by Petitioner and no case cited by the Tax Court or Respondent has held that payments were distributions of profits where all of the above facts were established in favor of a taxpayer. The requirements set forth in Treasury Regulation 118, Sec. 39.23 (a)—6 of the Internal Revenue Code of 1939 are substantially the same as have been found in favor of Petitioner. The case of *Am-Plus Storage Battery Co. v. C.I.R.,* supra, cited in the opinion of this Court uses the same criteria as those listed in the Treasury Regu-

lation. The decision of the Court was in favor of the Commissioner on the same issue as is here involved because the Commissioner established that the amounts paid as purported compensation were unreasonable and were in proportion to the stockholdings. The opinion of the Seventh Circuit states:

> "Hence, the real question here is whether Petitioner met the burden on it of showing that the allowances made and deducted were reasonable, leaving no substantial basis for the Board to arrive at the contrary conclusion."

The failure of the Tax Court to apply these criteria which were affirmatively established by the Petitioner is error as a matter of law, unless there are additional criteria to be applied which Respondent has established, and such criteria constitute substantial evidence.

What are the facts asserted by the Respondent, and do such facts constitute valid criteria in support of the ultimate finding of the Tax Court? The arguments of Respondent and the facts upon which he relies are set forth on pages 7 and 8 of the opinion of this Court. They will be individually examined.

Respondent argues that the compensation arrangement of Petitioner could result in all income being paid out as compensation. Assuming the truth of such an assertion, what possibly probative value can such a "fact" have in determining whether the payments are compensation or dividends in the years here involved? Perhaps this is one of the facts the existence of which invites "careful scrutiny" of a compensation arrangement, see 4 *Mertens, Law of Federal Income Taxation,* Section

25.64 (Rev. ed., 1954), at page 156, but it certainly is not true that every taxpayer who may have a loss for tax purposes has distributed profits under the guise of compensation. Certainly for the years under review, such an argument is not well taken, since in each of the years in question the Petitioner had substantial profits and paid income taxes (Tr. 15-20).

Respondent also argues that some of the compensation paid was from income not attributable to the services of the employee-doctors. Upon oral argument, much of the time allocated was spent upon an examination of this contention. Such an examination was unnecessary, and it is unfortunate the Petitioner neglected to point out the portions of the transcript set forth below. The assertion of Respondent in this regard is simply untrue and was not established by the Tax Court findings. This argument was initially advanced as the basis for the deficiency assessed (Tr. 121), but was rejected by the Tax Court which found (Tr. 42):

> " * * * It is not true either that the doctors did not render services to the hospitals. In a very real sense, but for the services they rendered to hospital patients, there would have been little, if any, hospital income. It is reasonable to conclude Petitioner would otherwise have been unable to utilize hospital facilities and would not have acquired them."

In addition, the doctors managed the hospitals and the other facilities of the Petitioner without compensation other than the amounts here under consideration (Tr. 59, 128-130).

That the fee schedule was raised several times is said to indicate that the fees listed represented the full amount of compensation payable to the doctors. In light of the corporate resolutions authorizing the total payments and the clear language of the employment contract, it is doubtful whether such an inference should be drawn. But assuming that there existed no contractual duty to pay more than the fees listed in the fee schedule, it does not follow that the payments in excess of the amounts so listed were distributions of the profits. This will be discussed below in considering the second ground of this Court's opinion.

Finally, the Court below found that the fees listed in the fee schedule of Petitioner constituted reasonable compensation. With this proposition there can be no quarrel. The Court below gave "full weight" to the testimony that the entire amounts paid were reasonable (Tr. 43), so, of course, any lesser sums would satisfy the "reasonable" requirement of the statute. But, again, what probative value does such a finding have on the issue of whether the total payments made were or were not compensation?

The Tax Court's determination of the question of fact here in issue must be based upon the application of one or more criterion sufficient to support its finding. In view of this Court's confirmation of Petitioner's compliance with four traditional and recognized criteria for determining whether particular payments constitute dividends or compensation, the determination of the Tax Court must not only be based upon a new and independent criterion, but such criterion must constitute

substantial evidence sufficient to counteract or nullify the four factors established by Petitioner. It is submitted that upon examiantion the arguments of Respondent and the facts relating thereto do not establish any such independent criterion, much less a criterion which can be labeled as substantial evidence.

It is submitted that to increase the burden on this taxpayer, or any taxpayer, by holding that the "facts" asserted by Respondent must be negatived in order to show that payments in fact were compensation, is to unnecessarily narrow the definition of "compensation" as the term is used in the statute; and to approve the argument of Respondent is to allow the Tax Court to make a finding "of fact" that payments to stockholder employees are distributions of profits any time a compensation plan based on profits *might* in the future result in the employer having no taxable income.

As a part of the second ground for its opinion, this Court accepts the conclusion of the Tax Court that the employment contract is ambiguous and authorizes the payment of only 100% of the base fees as compensation. Whether or not the contract is ambiguous is a legal question and can be determined by this Court as well as the Tax Court. *Quon v. Niagara Fire Insurance Co. of New York,* 190 Fed 2d 257 (CA 9th, 1951), and *Anzano v. Metropolitan Life Insurance Co. of New York,* 118 Fed 2d 430 (CCA 3rd, 1941). In light of the stipulation of the parties (Tr. 53-54) and the clear wording of the employment contract (Ex. 23, Tr. 105) Petitioner asserts that such a conclusion is clearly error. However, again assuming that such a conclusion is correct, it

establishes no basis for a holding that the payments in excess of the base fees were not "necessary." It is well settled that amounts paid for services rendered are deductible as compensation even though such payments were not made pursuant to the enforceable legal obligation. Indeed, any valid business purpose constitutes compliance with the "necessary" requirement of the statute. See for example the Treasury Regulation set forth below relating to bonuses and the cases cited in Respondent's letter, and compare *Dunn & McCarthy, Inc. v. C.I.R.,* 139 Fed 2d 242 (CA 2d, 1943). There is no dispute that the Petitioner paid the sums here in question pursuant to the authority of corporate resolutions authorizing the total payments as fees. Treasury Regulation (1939 Code) 118, Section 39.34 (a)—8, which is the same as Section 1.162-9 of the 1954 Code Regulations cited in Respondent's letter, reads as follows:

> "Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are not deductible from gross income."

In conclusion, it is submitted that the facts found by the Tax Court upon which Respondent relies do not and cannot logically constitute the proper criteria upon which to base a holding that amounts paid to stock-

holder-employees as compensation are dividends. To so hold is to go beyond the existing cases and to open up a vast area within which the Internal Revenue Service may disallow purported compensation payments which would otherwise be unquestioned as legitimate business expenses if it were not for the fact that they were paid pursuant to a plan based upon a percentage of profits.

In addition, this Court's holding that a portion of the payments were not "necessary" because voluntary is not supported by the existing cases and the Treasury Regulation on the subject.

The questions to be decided by this court are primarily questions of law, and the credibility of witnesses is not involved. Under such circumstances this Court may reexamine the decision of the Tax Court and substitute its own conclusion based upon the record.

WHEREFORE Petitioner respectfully petitions this Court for a rehearing herein and that this case be reconsidered and the decision of the Tax Court reversed.

Respectfully submitted,

MAUTZ, SOUTHER, SPAULDING,
DENECKE & KINSEY,

By JAMES R. MOORE,

Attorneys for Petitioner.

STATE OF OREGON)
) ss
County of Multnomah)

I, James R. Moore, of attorneys for Petitioner do hereby certify that the foregoing petition for rehearing is well founded in my judgment and is not interposed for the purposes of delay.

JAMES R. MOORE.

APPENDIX

December 30, 1958

CKR:LAJ:HAB:mo'b
5-9943

AIR MAIL

Mr. Paul P. O'Brien
Clerk
United States Court of Appeals
for the Ninth Circuit
San Francisco, California

Re: Klamath Medical Service Bureau
v. Commissioner (C. A. 9th—No. 16,025)

Dear Mr. O'Brien:

This office has received the opinion of the Court dated December 15, 1958, affirming the Tax Court decision in the above-entitled case in favor of the Commissioner. We have been somewhat concerned as to the possibility of language employed in the next to last paragraph in this opinion being seized upon and read out of context as conflicting with the well-established principle that amounts paid as compensation for services rendered constitute income to the recipient even though such payments were not made pursuant to an enforceable legal obligation. See, e.g., *Botchford v. Commissioner,* 81 F. 2d 914 (C.A. 9th); *Nickelsburg v. Commissioner,* 154 F. 2d 70 (C. A. 2d); *Davis v. Commissioner,* 81 F. 2d 137 (C.A. 6th); *Roberts v. Commissioner,* 176 F. 2d 221 (C.A. 9th), and see also Treasury Regulations (1954 Code), Section 1.162-9; *Bateman v. Commissioner,* 34 B.T.A. 351.

It is our belief that the Court did not intend such a construction to be placed upon its opinion and that the judges who participated in the case might wish to reconsider the wording of this paragraph in the light of this comment.

Sincerely yours,

CHARLES K. RICE
Assistant Attorney Generl
Tax Division

By: LEE A. JACKSON
Chief, Appellate Section

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